The Economic Lessons of 2005

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The first of the year is an appropriate time to review and preview. After all, January was named for the Roman god Janus, the god of beginnings, who was often represented with two faces, one looking backwards in time and the other looking ahead. So, like an economic Janus, I'll review a few of the biggest developments in economics in 2005. And I'll discuss how they may continue to affect us in 2006.

Here, in no particular order, are what I see as the biggest national economic stories of 2005.

Rising Energy Prices

This was the year that Americans woke up to the reality of rising energy prices. But long before the sharp increases caused by Hurricanes Katrina and Rita, prices were trending gradually up due to growth around the world, especially in China and India. Those two huge emerging economies are buying more automobiles, more gasoline, and more crude oil. The growth in global demand for oil is the single biggest factor in the steady increase in oil prices.

The fall's hurricanes caused disruptions in oil and gasoline supply that were relatively short-lived. Prices have fallen back to where they were, which means they are once again on a steady upward path. The price of crude oil is still $12 per barrel higher than this time last year, and the average price of gasoline is up 40 cents per gallon from a year ago.

The short-term picture for natural gas is bleaker, as production in the Gulf of Mexico has yet to recover entirely from the fall's hurricanes, and prices are more than double their level of a year ago. But natural gas's long-term outlook parallels that of oil. Expect more gradual increases in energy prices in 2006.

Hurricanes

The 2005 Atlantic hurricane season wreaked havoc in Florida, Mississippi, Louisiana, and Texas. The economic cost of the storms was well into the billions of dollars, and the human cost has been staggering. The city of New Orleans may never fully recover. Unfortunately, the recovery of the Gulf region doesn't appear to be a priority for the federal government. It may be that recovery shouldn't be a federal responsibility, but much aid was promised and so far little has been distributed.

Katrina and her fellow hurricanes had a mostly short-term impact on the national economy. The storms caused some inflation, but no forecasters expect it to persist far into 2006. There will certainly be a surge in construction activity, which some will mistakenly characterize as being "good for the economy," but that won't last forever either. In spite of the hurricanes, gross domestic product grew at a healthy pace in the third quarter of 2005.

Social Security Reform

One of President Bush's main goals for his second term was to change Social Security as we know it. Unfortunately for him, it was a tough sell and his efforts now appear to be dead in the water.

For the most part, Americans accepted the president's contention that the system needs shoring up. The number of workers required to support a retiree has fallen from 16 in 1950 to about 3 now, and it's expected to fall to 2 workers per retiree by 2030. Most commentators agree that some minor adjustments are needed.

But the public didn't believe that the situation is dire and requires immediate and drastic action. Even without adjustments, nonpartisan projections indicate that the system will be able to fully meet its obligations for another 35 to 50 years. The administration oversold its reform proposals by pushing for partial privatization of Social Security. The president lost credibility when he was forced to reverse his position and admit that privatization would do nothing to preserve the system's long-term fiscal integrity.

The End of the Housing Boom?

There was much debate in 2005 over whether there was a housing "bubble," i.e. an unsustainable boom in home prices. Home sales hit record heights thanks to low mortgage rates, and in some areas sellers fought off buyers who offered more than the asking price. However, the housing market was white-hot only in certain regions, notably the Northeast, California, and parts of Florida.

And then sales of new homes, a leading indicator of the overall housing market, fell 11 percent in November, the biggest monthly drop in over a decade. Even so, sales are still quite high, and few economists are predicting the bottom to fall out of the housing market in 2006. Rising mortgage rates will keep 2006 from being as good as 2005, but data on housing starts and residential building permits are still fairly strong. The most likely scenario in 2006 is a soft landing, not a burst bubble.

Not all of the big economic stories of 2005 occurred on the national stage. There was big economic news on the local and regional front as well.

The Las Vegas Challenge

The inaugural Las Vegas furniture market was held in July, and the reviews were boffo. There were over 60,000 attendees, and reports were that the market operated surprisingly smoothly for a first-time event. Suddenly voices in the industry started sounding death knells for the market in High Point. One said to a reporter, "I can't believe High Point can counter this."

Of course it's way too soon for death knells, but it was fascinating to hear such pessimistic rumblings after years of blithely optimistic talk coming out of High Point. Local officials heard the rumblings as well, with some realizing for the first time just how serious the Las Vegas challenge is. The High Point city council expressed concern with the way the market authority has run the market and it now wants to play a more active role, including the possibility of greater financial support. And it can't be a coincidence that the market authority is looking for a new president.

These are welcome developments, because Las Vegas has always been a bigger challenge than High Point seemed prepared to admit. But it's worth reminding ourselves that the game isn't over. High Point will almost certainly lose some business to Las Vegas, but that doesn't have to mean the end of the High Point market as we know it.

The July market in Las Vegas was notable for its lack of new-product introductions. Cheaper hotels and easy access to gambling are great, but at the end of the day, retailers will go where the new product lines are shown. The next Las Vegas show is later this month, and many will be watching the composition of the merchandise shown out there.

The Lottery

North Carolina finally voted to establish a state-run lottery in 2005, and the only good thing to be said about it is that money will no longer leave the state to be spent on lotteries in surrounding states.

State lotteries are bad policy, and not because gambling is bad (in fact, I like gambling). Lotteries are bad policy because they try to be both a tax and a retail product and they do a bad job of both. As tax programs, lotteries are regressive, extracting funds mostly from the poorest citizens.

But wait a minute, you say. Lotteries aren't really taxes because people don't have to buy lottery tickets. However, then they're like a regular retail product, and therefore it's hard to justify why the state should have an exclusive monopoly. Shouldn't any company be able to sell lottery tickets? And because of the monopoly, lotteries are a bad deal. Even casinos pay more in winnings than state lotteries do.

Even if we ignore the above problems, lotteries almost never deliver the benefits their supporters claim for them. They say that our new lottery will improve funding for education. But as a recent News & Record article noted, state revenues are fungible. States with lotteries tend to reduce education spending out of general revenues by the precise amount generated by the lottery. The net effect is zero. Unless North Carolina puts specific budgetary safeguards in place, the same will happen here.

But most of us wanted a lottery, and now we have one. So buy your tickets and try to forget that it taxes poor people, is a bad deal for you, and will do precious little for education.

Economic-Development Incentives

A year after state and local officials granted a record-breaking incentive package to Dell, the plant is up and running. Even though the Dell story appears to be over, incentives continued to make news in 2005. The new twist this year was a pair of attempts to grant incentives to retail establishments. In Wilson, the city and county granted $2 million in incentives for a Target store. In Greensboro, the city nearly approved $300,000 in incentives for a Wal-Mart store.

Even if one grants that incentives are reasonable for industrial developments, they are unreasonable for retail developments. Most industrial companies serve markets that are at least regional and perhaps national or international, which means that local incentives don't put their local competitors at a significant disadvantage.

But retailers usually serve local markets, which means that giving one retailer an incentive creates a *direct* disadvantage for its competitors. Instead of generating new jobs, retail incentives tend to shift retail jobs from one part of a city to another. In effect, retail incentives are a way for local officials to express a brand preference: for Target, for Wal-Mart, etc. That preference is best left to consumers.

However, as wrong-headed as retail incentives are, the incentives in Wilson are going through and the ones in Greensboro very nearly did.

In 2006, lawsuits against incentives will continue to wind their way through the courts. One lawsuit claims that economic-development incentives violate the state constitution; another claims they violate the federal constitution. This is one economic issue that won't go away.

What are the economic lessons of 2005? One is that external events (global oil demand, hurricanes) can hurt if we don't prepare for them. Another is that some bad policies (the lottery, retail incentives in Wilson) win the day, but others (Social Security reform, retail incentives in Greensboro) do not. And still another is that sometimes you have to fight hard for what matters (the furniture market). I hope that in 2006, you're ready for the unexpected, you do the right thing, and you fight the good fight.